

Administrative Aspects of Individual Accounts or The Devil is in the Details and He Could Spear You

Testimony before the House Budget Committee

(Testimony)

Author(s): Lawrence H. Thompson

Published: May 25, 1999

The nonpartisan Urban Institute publishes studies, reports, and books on timely topics worthy of public consideration. The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, its funders.

Many advocates of individual social security accounts implicitly assume that an acceptable strategy can be developed for implementing their plan. International experience suggests that this is a dangerous assumption. No country has yet successfully implemented individual accounts in a way likely to be acceptable in the U.S. Supporters of individual accounts need to pay more attention to administrative details if they want to avoid another catastrophic health fiasco.

One of the most contentious elements of the current debate about refinancing social security is whether to introduce a system of mandatory individual investment accounts. This part of the debate ranges across a variety of considerations. These include likely impacts of one or another course of action on: benefit adequacy, benefit predictability, rates of return to social security contributions, the progressivity of the retirement income system, the behavior of future political office holders, competing social philosophies, the macro economy, and the future fiscal position of the federal government. With so many dimensions to discuss, it is a debate that could go on for a long time and become quite confusing.

Most of the attention so far has been on policy trade-offs. They are important and should be thoroughly analyzed and debated. But, people who are serious about creating mandatory individual accounts must also focus on the practical aspects of how such accounts can be administered. Administration of these accounts is a case where the devil is truly to be found in the details. In this regard, a number of countries have created mandatory individual accounts of one form or another, and it is my belief that none of them has yet devised an administrative structure and strategy that is likely to be acceptable in the United States.

The competing objectives

Constructing a national system of individual accounts involves important choices which require balancing competing objectives. Quite likely, no structure can be devised that will achieve of the objectives fully. The challenge of somebody trying to design an individual account proposal for the United States is to decide which objectives to sacrifice in the interest of achieving others.

An outline summary of the different models proposed or implemented around the world is attached. The rest of this statement will concentrate on the competing objectives and the challenges in achieving them.

Among the important objectives that individual account systems are designed to achieve, five stand out:

1. Providing workers with a reasonable rate of return on their mandated contributions.

Particularly in the U.S., the case in favor of individual accounts almost invariably begins with the assumption that they would provide a higher return than does the traditional social security program. Getting decent returns, however, requires keeping administrative costs at reasonable levels and assuring that investment decisions are guided only by concerns of maximizing returns at acceptable risk. Experience elsewhere suggests these are more easily said than done.

Administrative costs are the Achilles Heel of all of the decentralized individual account systems currently in operation around the world. In the Latin American systems, roughly one-quarter of the money that goes into the funds is lost to administrative fees. In the U.K., administrative charges are averaging 40 percent of the system's resources. Before long, these countries will find that they are spending more than one percent of their GDP just to administer their pension systems. Australia and Switzerland have managed to avoid such high administrative costs by relying on employer-sponsored accounts rather than allowing the complete decentralization found in Latin America and the U.K. Sweden is trying to implement an alternative arrangement designed to avoid the administrative cost problems found in Latin America and the U.K., but the Swedes have encountered some practical problems and their system is not yet operational.

The costs associated with decentralized administration of the system must be weighed against the possible loss of returns if funds are held in a form and in a place where political interference can produce poor investment returns. One study tracking returns paid on accounts in the provident funds of Malaysia and Singapore concludes that they fell short of the market returns available elsewhere in

the respective countries by an amount roughly equal to the administrative charges found in Latin America. Apparently you get to pick your poison.

2. Assuring that contributions are handled responsibly and that excessively risky investments are avoided.

I am struck by several differences between the administrative processes used in public pension systems in the U.S., Sweden (and other OECD countries I have studied) and the processes used in other parts of the world. One of these differences has to do with the care taken in accounting for the money withheld from worker's paychecks. In the U.S., one of the most burdensome aspects of the earnings posting process involves double checking everything to make sure that the right amount was reported by the employer and that it is going to the right account. Something like one out of every ten earnings reports has errors that need to be followed up.

The Latin American individual account model embodies comparatively little of this care. In that model, reports of contributions flow into the system each month and are pretty much processed as they are received. In the last analysis, each worker must check his or her investment statements to make sure that their money really did get deposited correctly and must take the initiative to resolve any discrepancies that may arise when mistakes are found. That the Latin Americans do not check the data as closely as we do is more a reflection of the intrinsic character of the model than of the quality of their implementation. They are collecting information on each employee's contributions each month. I doubt that it is possible for any institution to process that much information every month and still run as many cross checks as the U.S. uses to process its information.

On the other hand, the Latin American model tightly regulates the kinds of investments that pension funds can undertake. Once the money makes it to the fund, the odds that it will be lost to excessively risky investment are minimized. In contrast, some of the proposals that have been made for the U.S. seem to be structured to encourage workers to invest in the riskiest assets possible. This is the logical result of guaranteeing current law benefits to those whose investments didn't work out.

3. Providing individual workers with a reasonable degree of choice about how their money will be invested.

Presumably, one of the advantages of individual accounts is the ability of workers to exercise more control over their retirement nest egg. Obtaining this advantage requires, however, that they be allowed some choice about investment forms and strategies.

Choice costs money. Though the U.K. system is expensive to operate, it does give each participant a wide choice of investment instruments. On the other hand, the Australian system has been criticized for not guaranteeing choice to workers. Australia is currently debating whether to mandate that each worker have at least four options, but pension providers warn that administrative costs would rise as a result.

On the other hand, spending lots of money doesn't guarantee a meaningful choice. The Latin American systems give participants little real choice about investment strategies. Owing to the structure of the guarantees built in to those systems and the regulatory strategies, every competing pension provider holds essentially the same portfolio of assets.

The Thrift Savings Plan model in the U.S. represents one attempt to balance choice and costs. Choice is provided, but it is sharply constrained by being limited to a handful of indexed funds that are defined by the plan but managed by private firms. To date, this has proved to be about the most efficient way to offer at least some degree of choice. But it requires a far more direct role for government in operating the system than many of the designers of systems in other countries would be comfortable with.

4. Avoiding an increased burden on employers.

Public policy in the U.S. is more sensitive to sparing employers undue burden than any other country I know. Many countries require all employers to file information electronically; those that do not require electronic filing at least require employers to file on standardized forms. We do neither.

The Australian and Swiss systems of individual accounts are administered fairly efficiently, but they are examples of a model that has been proposed and rejected in this country. Each is a variation on the Mandatory Universal Pension System (MUPS) plan proposed by President Carter's Pension Commission and rejected owing to the desire to avoid any further employer mandates.

The Latin American model also requires monthly reporting of every individual's earnings and contributions. In the U.S., we used to require such reports to be filed quarterly, but we reduced the frequency to once a year to lighten the burden on employers. It is doubtful that we would adopt a system that relied on monthly reporting by employers.

The price paid for avoiding monthly reporting is that the resulting system has major time lags built in. For example, both the U.K. and Sweden require only annual reports from employers. In both cases, therefore, the money withheld from a worker's paycheck sits around someplace for up to 24 months before it gets transferred to the fund of the worker's choice. Presumably, we would have to adopt the same policy in the U.S. In effect, money withheld from your paycheck in January 1999 won't be invested according to your preferences until around September 2000. The Federal Thrift Plan does not suffer from time lags like these. In this respect, it is not possible to build a system of individual accounts in the U.S. that will look like the Federal Thrift Plan.

5. Insulating the economy from inappropriate political interference.

A common fear voiced in the U.S. is that government ownership of a large portfolio of assets could give government undue influence over the economy through the influence it could exert on corporate management. Such concerns also helped convince the Swedes to

adopt a more decentralized approach, more or less as a replacement for a more centrally managed fund that has been part of their social security program since the 1960s.

The governance problem is usually raised in connection with proposals to invest the current trust fund in private securities. Presumably, however, to the extent that the concern involves how shares are voted and whether a subsequent Congress mandates divestiture of certain assets, the concerns are equally applicable to a system of government-operated individual accounts under a modified thrift savings plan model.

The challenge for the U.S.

If the U.S. decides to create a system of mandatory individual retirement accounts, it will have to also develop an administrative strategy for organizing the system and a management strategy for running it. We should expect that we will have to make serious compromises from the ideal in developing both. The result will likely *not* be something that looks like today's 401(k) plans. Indeed, we will probably have to create an entirely new institution to implement an approach that had never before been tried anywhere in the world.

What we can learn from experience abroad is what not to do. We don't want the employer burdens that are associated with the Australian, Swiss and Latin American systems. We don't want the administrative costs associated with the U.K. and Latin systems (indeed, at the contribution levels most people are discussing here, we couldn't possibly afford them.) Instead, we want choice, we want security, and we want the politicians to keep their hands off of the funds. Now we just have to figure out how to do it.

Summary of Individual Account Plans						
Plan:	Latin America ¹ (Chile)	Switzerland	Australia	UK	Sweden	CSIS ²
General Characteristics						
Is Participation Compulsory?	Yes	Yes	Yes	No	Yes	Yes
Contribution Rate	13 percent	7 to 18 percent	9 percent	4.8 - 5.8 percent	2.5 percent	2 percent
Budget Financing?	Transition	No	No	Partial	No	Partial
Who Collects?	Pension Fund	Pension fund	Pension Fund	Tax Authority	Tax Authority	Tax Authority (IRS)
Who Remits?	Employer	Employer	Employer	Employer	Employer	Employer
Who Maintains Records?	Pension Fund	Pension Fund	Pension Fund	Investment Mgr	Government	Government
Employer Reporting Frequency	Monthly	Monthly	Monthly	Annual	Annual	Annual
Investment Management						
Who Selects Investment Manager?	Worker	Social Partners	Employer	Worker	Worker	Government
Who Selects Investment Strategies?	Investment Mgr	Investment Mgr	Investment Mgr	Worker	Worker	Government
How Many Options for Workers?	None	None	0 to 5	Unlimited	Unlimited	4 or 5
Maximum Time Lag	Days	Days	Days	18-24 months	18-24 months	18-24 months
Withdrawal of Funds						
Lump Sum Withdrawal Allowed?	No	Up to 50%	Yes	Up to 25%	No	Limited
Annuities Mandatory?	No	Yes	No	Yes	Yes	No
- Price Indexing Required?	Yes	No	No	To 3%	Not decided	No
Who Picks Annuity Provider?	Worker	Pension fund	Worker	Worker	Government	Government
Guarantees:						
Absolute rate of return?	No	Yes	No	No	No	No
Relative rate of return?	Yes	No	No	No	No	No

Minimum Benefit?	Yes	No	No	No	No	No
Prior Law Benefit?	No	No	No	No	No	No
Solvency of Investment Company?	Yes	Yes	No	No	No	Implicitly
<p>1. Similar approaches are followed in the other Latin American countries as well as Poland and Hungary; others tend to use government to collect</p> <p>2. Proposal of the Center for Strategic and International Studies</p>						

Notes

1. Many of the issues discussed here are covered in greater detail in one of two papers: (1) "[Administering Individual Accounts in Social Security: The Role of Values and Objectives in Shaping Options](#)," which was issued earlier this year by the Retirement Project at the Urban Institute, and (2) "Managing Mandatory Savings Plans: The Implications of Foreign Experience," contained in the recent EBRI volume, *Beyond Ideology: Are Individual Social Security Accounts Feasible?*" All opinions are my own, and not necessarily those of the Urban Institute or any of its funders. [The Retirement Project](#) is made possible by a grant from the Mellon Foundation.

Email this Article

The nonpartisan Urban Institute publishes studies, reports, and books on timely topics worthy of public consideration. The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders.